Thrasher, Sandra Jo

From: john_kingston@platts.com
Sent: Thursday, September 11, 2003 2:04 PM
To: MRM Comments
Subject: Platts comments on MMS proposal

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Please find attached our comments the proposed rule on federal royalty valuation.

(See attached file: final letter for mms.txt)

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September 11, 2003

Minerals Management Service
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To the ladies and gentlemen of the Minerals Management Service:

Platts would like to take this opportunity to comment on the changes that the Minerals Management Service is proposing to determine the value of oil for the purpose of payment of federal royalties.

We will not offer an opinion on the merits of the proposed changes. As an unbiased observer of these matters, we take no sides. However, Platts' position as the primary supplier of price benchmarks to the oil industry, and the concurrent knowledge of our own methodology, has led us to take this unusual step of commenting on some aspects of the MMS proposal that specifically involve the benchmarks produced by Platts and other publications.

However, we would like to note that we question whether the changes address your stated concern: the perceived lack of liquidity and transparency in the existing West Texas Intermediate assessment, and the strategy to address that concern, a shift to the New York Mercantile Exchange price as a basis for calculations. The recent revelations in the power and gas market regarding incorrect reporting of data, as you note, are a key reason for your proposed shift.

As we read through the proposal, and speak with people in the market, we believe we must take this opportunity to defend Platts' current methods for assessing WTI. Although Platts is not named in your proposed rule, and there are other publications that are acceptable by MMS for determining royalty values, we have detected in the industry a sense that your proposal is a veiled critique directed at Platts. We have been assured by MMS personnel that is not the case, but the public perception does exist.

We therefore want to use this forum to note that Platts' WTI assessment is produced each day through a highly transparent and open process known as the Market on Close (MOC) methodology. It involves a 30-minute trading window following the close of trade on NYMEX, in which market participants post bids and offers to Platts. We in turn relay those bids and offers to the market through our Platts Global Alert (PGA) system, and we identify the name of the parties publicly. PGA publishes precise information on the buying and selling activity in the 30-minute window, e.g., Company A bids 4 cts over settle (the NYMEX settlement), company B offers 2 cts under settle, and so on. Through this process, all interested parties are able to see clearly the process that leads up to the Platts WTI assessment that we post each day. While the number of participants is not at the level of NYMEX, the transparency is extremely high, and the accuracy of the Platts WTI assessment is equally high. We continue to monitor our procedures for signs of manipulation, and will always strive for transparency and accuracy. We believe our current method eliminates opacity and provides clear information on how we reach our settlement.

Our second observation is similar to one that MMS makes in its proposed rule. The MMS all but concedes in its proposed rule that virtually all non-arm's length transactions utilizing the NYMEX price will need to work back to the value of the oil at the wellhead. The agency further states that to do so, a publication will need to be utilized to calculate the value at a market center such as St. James, Louisiana. Therefore, the move away from the publications to what you see as a more transparent NYMEX ultimately can't get away from published assessments for the vast majority of royalty payers.

But we believe that half-and-half approach -- NYMEX as the basis, published differentials for market center values -- has the potential to create several accuracy problems.

Our concern at the first reading of the proposed rule was that the differential for a grade such as LLS (as an example) was going to be calculated by comparing the spot price of LLS in a publication such as Platts to the price of NYMEX crude. Such a step would create a basis risk, since the LLS price would be based on our cash WTI assessment, which does not align with the NYMEX settlement. However, further research has clarified that the WTI/LLS spread (for example) will be created by comparing the cash WTI assessment to a cash LLS assessment. The difference between the two would then be applied against the NYMEX price. This would eliminate the basis risk that concerned us in the beginning.

However, given that method, we question whether the move to a NYMEX basis accomplishes your goals. First of all, as we have noted, we believe our cash WTI assessment is produced in an open and transparent method. But even for those in the industry who do not fully accept that, they do need to acknowledge that the MMS proposal still provides an exposure for most of the industry to the cash WTI market, since that price will be one component in determining the value at the market center. The MMS appears to be trying to get away from a price that they believe might be manipulated, but ultimately conceding that it can't do that completely.

However, the move to a NYMEX basis creates other problems. Most glaringly, for the three days between the expiration of a particular month's NYMEX contract, and the concurrent close of cash WTI trading and pipeline scheduling for that same month, there will be a different basis for the NYMEX value and the differential to the market center.

For example, on May 23-24-25, with June NYMEX having expired, the primary component of the NYMEX value calculated by MMS will be July NYMEX crude, along with August and September as part of the "roll." But Platts' cash WTI for those three days will be June basis, and the WTI differential will be calculated by comparing June WTI to June LLS. That June-basis differential then will be applied against a NYMEX roll that has no element of June in its calculations. Following the 25th, this disconnect would disappear, only to surface again the following month.

It can not be assumed that in the market, the LLS differential for June will be equivalent for July barrels. However, those two elements are linked for three business days. In a month that only has 20 business days, these three days after the NYMEX roll/before the cash roll would constitute 15% of the days calculated for a monthly average. For a 21-business day month, that drops to more than 14%, still a substantial figure. Those percentages will constitute a figure representing the size of the disconnect.

In a related concern, we see a flaw in the combination of the "roll" mechanism with the application of the WTI differential. We make these comments without taking a specific position on the roll mechanism itself. Your proposal calls for a NYMEX basis price that is made up of parts of three months of NYMEX settlements. (We would also like to note that Platts assesses three months of WTI prices. The use of the NYMEX forward months is not the only way to capture forward value; Platts also has this data.) However, in determining value at the market center, you will be applying only one month's WTI differential for a grade such as LLS against a hybrid of three months. It can not be assumed that, for example, the WTI/LLS differential for August also will apply for September and October.

Platts does concede that we do not assess more than one month out for any grades, with the exception of Mars, where we now assess two months and have plans to add a third. Our decision not to assess those further months is driven by an almost complete absence of liquidity in out-month trading in those grades, not by any reluctance to provide that data. So while there is no simple solution for putting three months' of WTI differential into a comparison against the three months included in the NYMEX roll, we did want to note it. (Since you are not planning on using the roll for California, this problem will not exist. However, the three-day disconnect noted earlier will be a factor for that market.)

It should also be noted that the NYMEX crude contract is not a strictly WTI-based contract. Other grades are deliverable against it, and there are periods when the value of NYMEX crude is not equal to cash WTI for the same delivery month. For example, ownership of physical WTI always means you will be delivered physical oil. Ownership of a NYMEX contract generally is settled without the use of the actual commodity. During times of tight supply, the knowledge that a party that is long physical WTI will be getting oil can give it a premium to a long NYMEX position. A premium can develop also if the market perceives that a significant amount of non-WTI crude is going to be delivered against the contract. Platts tracks this value, known as Exchange for Physical (EFP). While it is generally zero, it has been as high as seven cents since Platts first began assessing it in April 2001. (Veterans here at Platts recall during the runup to Gulf War I, it reached 15 cts).

Platts wishes to make two other observations:

* The proposed MMS rule asks whether an additional Rocky Mountain benchmark may be found in Canadian prices at Hardisty. Please note that Platts recently has added spot assessments for Lloyd Blend at Hardisty. Lloyd Blend is a heavy sour crude, and unlike other postings-derived assessments for Canadian crudes, Platts' new Lloyd Blend, Mixed Light Sweet and Light Sour Blend assessments are true free-market assessments, produced from our survey of the market.
* The decision not to use weekends and holidays is the same process Platts uses in determining its monthly averages.

I visited MMS' Denver office in February with my colleague Liane Kucher to discuss our methodology for producing both oil and natural gas assessments. We will make a standing offer to MMS to work face-to-face with your staff in Denver or anywhere else should you wish to discuss these issues further.

Sincerely,

John Kingston

John Kingston
Global Director of Oil
Platts